

## APPENDIX H

# Evidence and analysis on Test C

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## Introduction

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- H1 Test C requires the assessment of whether for users of airport transport services the benefits of regulation are likely to outweigh the adverse effects.
- H2 This appendix outlines:
- The framework for the assessment of Test C.
  - A summary of the CAA's assessment of Test C as outlined in the Consultation on Heathrow market power assessment, CAP 1051 (the Consultation).<sup>1</sup>
  - Stakeholders' views on the Consultation.
  - The CAA's analysis.
  - The CAA's conclusion on whether Test C is passed.

## Assessment framework

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- H3 Test C of the market power test requires '*that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects*'.<sup>2</sup>
- H4 The relevant operator is '*the person who is the operator of the airport area at the time the test is applied*'.<sup>3</sup>
- H5 Users of air transport services are defined in the Civil Aviation Act 2012 (the CA Act) as passengers or those with a right in cargo and future users of such services.<sup>4</sup>
- H6 Test C forms part of the market power test that must be satisfied before the CAA can decide whether to impose a licence, and if so on what

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<sup>1</sup> This document is available on the CAA's website:

<http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=5576>.

<sup>2</sup> CA Act, Section 6 (3).

<sup>3</sup> CA Act, Section 6 (2).

<sup>4</sup> CA Act, Sections 69 (1) and (2).

conditions, pursuant to sections 15 to 18 of the CA Act. Test C requires the CAA to assess whether the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects. Test C does not expressly require the CAA to apply this test by reference to a specific set of licence conditions (regulatory obligations). Such a requirement would reverse the logical structure of the CA Act, and would require the determination of individual licence conditions before the decision of whether to impose a licence is made.

- H7 However, in the present case, due to the logistical timetable of implementing the CA Act in time, the market power assessment has had to be undertaken in parallel to the CAA's Q6 review of the possible forms of regulation for HAL after April 2014. In these circumstances, the CAA has considered Test C by reference to the form of licence regulation which it considers to be most appropriate for HAL. As further explained below, in the present case, this is Regulatory Asset Based (RAB) regulation as reflected in the Q6 Final Proposals for HAL (referred to below as the RAB Licence).
- H8 The CA Act does not dictate a particular method of impact assessment and as a result such an assessment may be qualitative or quantitative or a combination of both depending upon the availability of the relevant data. Where it has been reasonably practicable to quantify the respective benefits and costs, the CAA has done so. Nevertheless, the CAA has also assessed qualitative factors. The CAA has then exercised its regulatory judgment in weighing those factors to apply to Test C.
- H9 As required by the CA Act, when assessing the benefits of imposing licence regulation on the relevant operator, the CAA has carried out its functions in a manner which will further the interests of users of air transport services as defined by the CA Act (passengers and cargo owners) and, where appropriate, to do this by promoting competition, having regard to certain specified factors.<sup>5</sup> As part of the assessment the CAA must consider the extent to which any likely net benefits are transposed into user benefits.
- H10 Under section 1 (5) of the CA Act, if the CAA considers there is a conflict between the interests of different classes of user or between the interests of users in different matters its duty is to carry out its functions in a manner which it considers will further the interests of those it thinks best. The CAA's approach to balancing these different needs is set out in the Q6 Final Proposals.

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<sup>5</sup> Section 1(3)(4) of the CA Act.

*When balancing the needs of passengers' interests the CAA is conscious of the need to protect against the risk of abuse of [Substantial Market Power] SMP. Consequently where an airport operator has SMP over all passengers (as identified in the minded to assessment), albeit the requirements of different groups of passengers differ, the CAA has focused regulation where the risk of abuse of market power and potential detriment to passengers is greatest. (...) The CAA recognises that this is likely to benefit some passengers more than others, although the CAA considers it will minimise distortions by focusing this protection on the cost of a minimum bundle of common services. This approach allows passengers that have higher service quality requirements to purchase this additional quality, rather than impose these higher costs and quality on all passengers. The CAA considers where an airport operator has SMP over all passengers, and there are trade-offs between different groups, the CAA should seek the outcome that provides the greatest overall benefit.*

- H11 The CA Act also sets out the provisions for granting a licence and what a licence may contain.<sup>6</sup> A licence may include such conditions as the CAA considers necessary or expedient in relation to the risks of abuse of market power and any other conditions the CAA considers necessary or expedient having regard to the CAA's duties.<sup>7</sup>
- H12 The CAA has also had regard to the regulatory principles in section 1(4) of the CA Act and the duty not to impose unnecessary regulatory burdens on operators of dominant airports.<sup>8</sup> These provisions, in essence, build in a proportionality exercise to Test C to ensure that ex ante regulation via a licence is only imposed where it is suitable, necessary and proportionate.

### The relevant factual scenarios

- H13 The CAA's consideration of the benefits and costs of a licence regime under Test C has focused on the form of regulation which is RAB-based regulation that reflects the Q6 Final Proposals. This is the form of regulation that the CAA has set out in its notice of the proposed licence and associated licence conditions, which has been published at the same time as this document. That notice also sets out the reasons for the choice of this form of regulation and licence conditions.
- H14 The CAA refers to this below as the RAB-based Licence.

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<sup>6</sup> Sections 15 to 21 of the CA Act.

<sup>7</sup> Section 18(1) of the CA Act.

<sup>8</sup> Section 73(2A) of the Regulatory Enforcement and Sanctions Act 2008.

- H15 For completeness, the CAA has also considered the costs and benefits of regulation by means of a general licensing regime that is not in the form of the RAB Licence. The CAA refers to this below as Licensing Generally.
- H16 It is also necessary for the CAA to form a view of the counterfactual to a licence regime. The CAA has therefore assessed the costs and benefits of regulation against the counterfactual situation in which there is no licence in place.
- H17 That counterfactual situation also includes other forms of regulation that currently exist, irrespective of any licence, most notably the Airport Charges Regulations 2011 (ACRs) and Airports (Groundhandling) Regulations 1997 (AGRs) as well as competition law. This regulatory framework is referred to as the Existing Regulation.
- H18 Lastly, to ensure the proportionality of the form of licence regulation in contemplation, when assessing the respective costs of licence regulation, the CAA has conducted a comparison between the RAB licence and other possible forms of regulation. The CAA's conclusions on that matter are set out in the Q6 notice but in the course of its assessment of Test C it has drawn comparisons between the RAB Licence and other forms of licence regulation in respect of specific impacts.

## The Consultation

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- H19 In the Consultation, the CAA considered the merits of RAB-based licence regulation of HAL against the adverse effects. The CAA concluded that, in the case of HAL, the benefits to users of licence based regulation outweighed the adverse effects of such regulation.
- H20 The CAA also considered that, given the level of market power identified in relation to HAL, the ACRs or AGRs would not necessarily provide sufficient protection for users.<sup>9</sup>
- H21 In addition, the CAA considered that, despite the possible distortion regulation may cause, there was currently minimal distortive effects arising the impact of regulation through price<sup>10</sup>, efficiency<sup>11</sup>, service quality<sup>12</sup> and investment.<sup>13</sup> However, given the market position of HAL, the CAA considered that it was likely that, where such distortions did

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<sup>9</sup> Where the CAA refers to passengers it also refers to current and future passengers and those with a right in cargo.

<sup>10</sup> The Consultation, paragraphs 9.36 to 9.51.

<sup>11</sup> The Consultation, paragraphs 9.52 to 9.60.

<sup>12</sup> The Consultation, paragraphs 9.61 to 9.68.

<sup>13</sup> The Consultation, paragraphs 9.69 to 9.74.

arise, the adverse effects of regulation would be outweighed by the benefits of regulation.

- H22 Analysis outlined in the Consultation also showed that HAL had a lower level of efficiency when compared to similar airports. Given the lack of competition that HAL was exposed to, the CAA considered that HAL would face limited pressure to tackle these inefficiencies absent licence regulation.<sup>14</sup>
- H23 On service quality, the CAA considered that the evidence showed that HAL has a good service quality record, although it was difficult to isolate the motivations for its current performance. The CAA also noted that HAL appeared to perform very well in some areas, to the detriment of others service areas.<sup>15</sup>
- H24 The CAA also outlined that there were benefits to users by having good operational resilience plans for times of disruption. This was a key issue for HAL, especially with respect to recent performance in snow conditions.<sup>16</sup> Similarly, benefits were likely to accrue to users from a financially resilient airport.<sup>17</sup> The CAA therefore considered that a licence condition targeting resilience could bring substantial benefits to users.
- H25 The CAA also recognised that licence regulation may displace, to some extent, a more commercial approach by airports. However, it also noted that licence regulation would not preclude the ability of the airport operator to negotiate bilateral arrangements with its airlines.<sup>18</sup>
- H26 In addition, the CAA recognised that there would be some level of management distraction with any form of economic regulation which would not be present in a deregulated environment. However, it considered that licence regulation could be tailored to minimise these impacts.<sup>19</sup>
- H27 The CAA also estimated that the direct costs of licence regulation for HAL would be likely to be in the region of £12 million per annum. The CAA also estimated that its proposed price control for HAL was, on average, some £295 per annum lower than HAL's proposed pricing.<sup>20</sup>

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<sup>14</sup> The Consultation, paragraph 9.60.

<sup>15</sup> The Consultation, paragraph 9.65 to 9.68.

<sup>16</sup> The Consultation, paragraph 9.76 to 9.83.

<sup>17</sup> The Consultation, paragraph 9.84 to 9.87.

<sup>18</sup> The Consultation, paragraph 9.98 to 9.100.

<sup>19</sup> The Consultation, paragraph 9.101 to 9.102.

<sup>20</sup> The Consultation, paragraph 9.88 to 9.95.

## Stakeholders' views

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- H28 The CAA received three responses to the Consultation, from:
- HAL;
  - London Airline Consultative Committee (LACC) & Heathrow Airline Operators Committee (AOC); and
  - Virgin Atlantic Airways (VAA).<sup>21</sup>
- H29 HAL considered that the CAA focussed on a marginal price benefit, in the context of the overall ticket price, without considering the benefits to both airlines and passengers stemming from its investments. HAL's response suggested that this was not a reasonable or proportionate approach to the interests of users.<sup>22</sup>
- H30 HAL disputed the CAA's estimate of the direct benefits of regulation and considered that:
- The CAA had overestimated the direct benefits of regulation at approximately £295 million per annum as it had assumed that HAL's initial business plan would have been implemented without change.
  - The direct benefits of regulation are approximately £125 million per annum based on five year average aeronautical revenue of £21.93. While it noted that this was still positive, it also considered that this represents little more than the difference in price profiles as opposed to an estimate of the direct benefits of regulation.<sup>23</sup>
- H31 HAL also considered that the CAA's cost-benefit analysis suffered from a number of methodological caveats as it failed to account for and/or to quantify several issues which made it difficult to assess the relative cost.<sup>24</sup>
- H32 In addition, HAL noted that, according to the CAA, the most common forms of abuse were excessive pricing and/or service quality reductions and that:<sup>25</sup>
- While it recognised the difficulties in assessing cases of excessive pricing it believed that the CAA had sufficient knowledge and experience to do so.

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<sup>21</sup> Non-confidential versions of those documents are available on the CAA's website.

<sup>22</sup> HAL, Response to CAA's Market Power Assessment, 26 July 2013, paragraph 4.1.2.

<sup>23</sup> HAL, Response to CAA's Market Power Assessment, 26 July 2013, paragraph 4.1.3 to 4.1.4.

<sup>24</sup> HAL, Response to CAA's Market Power Assessment, 26 July 2013, paragraph 4.1.5 to 4.1.6.

<sup>25</sup> HAL, Response to CAA's Market Power Assessment, 26 July 2013, paragraph 4.1.7 to 4.1.11.

- It was difficult to reconcile the CAA's view that excessive airport charges passed to passengers would directly impact their ability to travel with the CAA's statements made either in the context of the market power assessment or in Initial Proposals (according to which airport charges were only a small fraction of the airfare and a small percentage of an airline's operating expenditure (opex)).
- The CAA's view that, in cases where airport charges increases were not passed to passengers, airline profitability would be affected was an unsubstantiated qualitative assertion. HAL also noted that it would welcome a detailed analysis from the CAA on this issue as it would enable it to measure more accurately the potential costs to passengers if regulation was absent.
- The CAA had not established either the potential for or the cost of passenger harm. HAL considered that clear evidence was required on the likely and additional costs to passengers if economic regulation was absent.

H33 The LACC & AOC agreed with the CAA that the benefits of a robust licence-based approach outweighed the costs of regulation and that the ACRs and AGRs did not provide sufficient protection to users of air transport services.<sup>26</sup>

H34 VAA agreed with the CAA's assessment of the benefits of licence-based regulation.<sup>27</sup>

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<sup>26</sup> LACC & AOC, Response to CAA's Market Power Assessment of Heathrow Airport Limited, p. 3.

<sup>27</sup> VAA, Response to CAA Consultation on Heathrow Market Power Assessment, p. 2.

## The CAA's analysis

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- H35 In light of the representations from stakeholders as part of the Consultation, the CAA has re-evaluated its assessment of Test C and considers that Test C is met. This view is consistent with the view outlined in the Consultation.
- H36 This section is structured as follows:
- Assessment framework.
  - RAB Licence vs. the Existing regulation:
    - prices;
    - efficiency;
    - service quality;
    - investment incentives;
    - other potential benefits of licence regulation;
    - direct costs; and
    - other adverse effects.
  - General Licensing vs. the Existing regulation: considering the same areas as under a RAB-licence.
  - An overall conclusion of whether the benefits of licence regulation are likely to outweigh the adverse effects.
- H37 The assessment focuses on the potential impact on passengers and, where relevant, considers the impact on cargo, particularly with respect to excessive prices. There are few freighter operations at Heathrow; cargo is mainly carried in the belly-hold of passenger airlines. Accordingly, there is a degree of overlap between the interests of passengers and cargo-owners.

## Assessment framework

- H38 HAL raised a number of concerns over the CAA's approach to assessing the costs and benefits of regulation. With respect to HAL's concern that the CAA had not sought to quantify any other potential costs of regulation or potential distortive effects and as a result it was difficult to properly assess the cost-benefit balance, the CAA notes that:



- The CAA is required by the CA Act to provide its assessment on whether the benefits of regulating the relevant operator are likely to outweigh the adverse effects. The CA Act does not dictate the approach to the CAA's assessment. Such an assessment may be qualitative or quantitative and the CAA has made every effort to quantify the relevant costs and benefits wherever this was reasonably practicable wherever a robust quantification was feasible.
- As stated in the Consultation, the CAA agrees with the view that there are other costs of regulation or potential distortive effects. However, those costs and potential distortive effects are difficult to quantify with an acceptable degree of reliability and as a result, where quantification has not been reasonably practicable, the CAA has sought to assess the cost-benefit balance through a qualitative analysis.
- HAL refers to other potential costs of regulation or potential distortive effects without actually referring to or identifying any specifics. HAL's comment appears to be a general criticism applying to any cost-benefit analysis where quantification of all likely costs and benefits is not possible. HAL did not provide a quantification of the potential costs. Such a general critique is also not particularly useful in further developing the CAA's cost-benefit exercise required by Test C.

H39 In relation to HAL's concern that *'the CAA's qualitative cost-benefit exercise does not provide an assessment of the benefit of avoiding passenger harm'* and that *'the CAA has not established either the potential for or the cost of passenger harm'*, the CAA considers that:

- Although the existence of dominance or SMP is not prohibited under competition law, the presence of SMP is a prerequisite for the potential of harm to the competition and final consumers.
- The potential for HAL abusing its SMP through excessive pricing is established by the following facts.
- HAL prices to the cap in accordance with its published charges of use without entering into negotiations with the airlines to offer discounts (see appendix F).
- The price proposed by HAL for Q6 is significantly higher than that of the CAA.

- HAL's prices are consistently well above the average price of comparable hub airports as indicated by the Leigh Fisher study (see appendices F and G).<sup>28</sup>
- H40 Furthermore, the CAA has already concluded under Test B (see appendix G) that competition law will not be sufficient to protect against the risk of exploitative abuses in the form of excessive pricing or detriment to service quality by HAL.
- H41 Therefore, on the basis of the above, and given HAL's SMP, the CAA considers that if HAL was unregulated there is a risk of HAL raising prices and transferring surplus from its users to its shareholders.
- H42 As discussed in the Consultation, the price difference between HAL's and the CAA's proposals imply that RAB licence regulation constrains HAL from capturing a rent of £295 million per annum from the airlines and ultimately the passengers. As such the pricing difference provides a measure of potential passenger harm against which regulation via a licence would provide protection.
- H43 With respect to HAL's comment in respect of the CAA's view that airport charges increases are likely to adversely affect airline profitability is merely an unsubstantiated qualitative assertion, the CAA notes (as outlined earlier) that:
- The airline sector within the UK and Europe is now regarded as a highly competitive market with minimum level of profitability. As a result, the CAA would expect a large part of any exogenous reduction in airport prices to be passed onto passengers, otherwise the airline would lose passengers to competitors who had lowered their price. Similarly, increases in airport charges would to some extent lead to fare rises (or a reduction in quality or choice of services) as airlines seek to maintain a minimum level of profitability.<sup>29</sup>

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<sup>28</sup> The Leigh Fisher study is available on the CAA's website.

<sup>29</sup> SLG Economics Ltd, Q6 review of the distribution of economic rent between airport, airlines and passengers and cargo users at Heathrow and Gatwick: A Report for the CAA by SLG Economics Ltd, September 2013 and SLG Economics Ltd, Q6 review of the distribution of economic rent: A response to comments from Compass Lexecon: A Report for the CAA by SLG Economics Ltd, December 2013.

- Looking at the empirical evidence over the last 10 years, both air fares and costs have fallen in real terms<sup>30</sup> while there has been strong growth in GDP (a good proxy for passenger demand). This suggests that airlines have not been able to capture much of the potential increase in economic rent; instead the competitive pressures have led to cost reductions being passed to passengers as lower fares.

## RAB-based Licence vs. Existing Regulation

H44 In this section, the CAA assesses the incremental benefits and adverse effects of imposing regulation on HAL in the form of a RAB Licence reflecting the Q6 Final Proposals compared to the Existing Regulation counterfactual.

H45 In particular, the CAA considers:

- The Existing Regulation.
- Assessment against specific impacts (in terms of the incremental benefits and adverse effects of the RAB licence).

## The Existing Regulation

H46 Given that HAL holds a position of SMP in the relevant market, the CAA has considered the constraints upon HAL's behaviour arising from the Existing Regulation comprising the ACRs, the AGRs and competition law.

## Airport Charges Regulations

### *The Consultation*

H47 All three of the currently designated airports will remain subject to the ACRs regardless of whether they are removed from the licensing regime under the CA Act.<sup>31, 32</sup> The ACRs came into effect in November 2011 and transposed into UK law Directive 2009/12/EC of the European Parliament and of the Council of 11 March 2009 on airport charges. The ACRs provide airlines (but not directly passengers) with a number of protections, including the following requirements:

- Airport operators must consult annually with airlines on airport charges and service quality.

<sup>30</sup> Source: CAA.

<sup>31</sup> The Airport Charges Directive can be found at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:070:0011:0016:EN:PDF>.

<sup>32</sup> The ACRs can be found at: [http://www.legislation.gov.uk/ukxi/2011/2491/pdfs/ukxi\\_20112491\\_en.pdf](http://www.legislation.gov.uk/ukxi/2011/2491/pdfs/ukxi_20112491_en.pdf).

- Airport operators have to provide airlines with information about the overall cost structure and revenues relevant to charges.
- Four months' notice of changes to the system or level of airport charges or to the quality of service associated with an airport charge.
- Airport charges must not discriminate between airlines except on relevant, objective, and transparent criteria, which can include cost and the quality and scope of services.
- Airport operators must consult airlines on major infrastructure projects.

H48 If an airline considers that an airport operator has breached one of these requirements, it can take action in the courts to recover loss or damage, or complain to the CAA. If the CAA receives such a complaint it must investigate and can give a compliance order on the airport operator and order any damage or loss be remedied.

H49 In the Consultation, the CAA considered that, given the level of market power identified in relation to HAL, the ACRs would not necessarily provide sufficient protection for users interests as:

- The ACRs do not require charges to be cost reflective and do not seek to control the overall level of charges and hence are unlikely to provide sufficient protection against excessive prices.
- The ACRs are likely to provide limited incentives for the airport operator to be efficient and although they require the airport operator to provide information on the overall costs structure and costs associated with different airport charges, this information is unlikely to be sufficiently detailed to allow airlines to robustly challenge the efficiency of airport costs to gain assurance where an airport operator has SMP, like HAL.
- The ACRs are likely to provide limited incentives to provide an efficient level of service quality where an airport operator has SMP, as negotiations on service quality level held under the ACRs may not approximate to those that would be conducted in a competitive market.
- Although the ACRs require the airport operator to consult on investment it does not require the airport operator to undertake an efficient level of investment and in case of an airport operator with SMP there is risk that it may undertake investment inefficiently (as costs can be passed on to users) or delay the required investments, reducing future service quality.

- The ACRs impose a duty on the CAA to investigate whether any of obligations in the ACRs have been breached only where there has been a complaint by an airline or another airport operator.
- Although the CAA can give a compliance order and take action to enforce such an order, it is likely to be difficult to make an order aimed directly at any losses sustained by end users because of the challenge of indentifying those affected and quantifying their losses.

#### *Stakeholders' views*

H50 The CAA did not receive any responses that directly mentioned the protection from the abuse of SMP from the ACRs.

#### *CAA views and position*

H51 For the reasons given above and in the Consultation, the CAA continues to consider that the ACRs will not provide sufficient protection against the risk of abuse of SMP to be in users' interests.

### **Airports (Groundhandling) Regulations**

#### *The Consultation*

- H52 The AGRs transpose the European groundhandling directive into UK law. Groundhandling covers a multitude of activities including check-in, handling baggage, cargo and mail, re-fuelling aircraft, and transporting passengers and crew to aircraft.
- H53 Under the AGRs, operators of airports with more than 2 million annual passengers cannot restrict the number of self handling airlines or third-party groundhandlers that operate at the airport without a determination from the CAA. There are currently no restrictions on the number of handlers in the UK.
- H54 Where handlers use aircraft facilities, such as check-in desks, baggage belts and fuel hydrant systems, the airport operator must set its charges according to relevant, objective, transparent and non-discriminatory criteria. The CAA can investigate alleged breaches of the AGRs.
- H55 The CAA considered that, given the level of market power identified in relation to Heathrow, the AGRs would not provide sufficient protection for users.

### *Stakeholders' views*

H56 The CAA did not receive any responses that directly mention the protection from the potential abuse of SMP from the AGRs.

### *CAA views and position*

H57 For the reasons given in the Consultation, the CAA continues to consider that the AGRs would not provide sufficient protection against the risk of abuse of SMP to be in users' interests.

### **Competition law**

H58 As discussed in appendix G (Test B), the CAA considers that competition law alone will not provide sufficient protection against the risk of HAL engaging in conduct that amounts to an abuse of its SMP.

### **Conclusion**

H59 As the foregoing makes clear, the CAA considers that the Existing Regulation offers limited protection for users where an airport operator has SMP. The CAA has, where appropriate, taken into account the impact of Existing Regulation as part of its assessment of Test C.

### **Summary of the RAB Licence**

H60 As discussed earlier, the CAA considers that the unique circumstances surrounding the implementation of the CA Act allow it to assess Test C based on a specific form of licence, i.e. the RAB Licence.

H61 The CAA's notice of the licence, issued at the same time as this document, sets out the specific licence conditions and other regulatory measures it intends to include which form the basis for the assessment of the Existing Regulation counterfactual. The notice includes amongst others the following proposed licence conditions relating to:

- Price control;
- Service quality;
- Efficiency of procurement capital projects;
- Financial resilience; and
- Operational resilience.

## Assessment of specific impacts

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- H62 The CAA has considered a series of specific impacts that, in terms of the likely benefits and adverse effects, it considers are important for furthering users' interests, promoting competition and complying with its general regulatory duties. It has also considered the cost implications of licensing.
- H63 Although, for presentational purposes, the CAA lists these issues separately and deals with them in turn, its assessment has looked at the impact of licence regulation in aggregate.
- H64 In its assessment of the indicators of market power (appendix F), the CAA set out its history of its consultation, stakeholders' views and its analysis and final conclusions in relation to a range of issues, including HAL's pricing, efficiency and service quality. In discussing the specific impacts of regulation on these areas, the CAA has drawn on and refers to this analysis as appropriate.

### Impact 1: Protection against excessive prices

- H65 In this section, the CAA discusses its consideration on the costs and benefits to users of the RAB licence in reducing the risk of excessive pricing. As set out in Section 6(8) of the CA Act conduct may, *in particular*, (emphasis added) amount to an abuse of SMP if it is conduct that is described the Chapter II prohibition in section 18 of CA98. As such, the CAA considers that there could be a range of potential abuses that act to the detriment of users between its view of a fair price and a price that would be considered excessive under competition law. The necessary level of protection against excessive pricing is therefore considered by reference to the potential harm that may arise from any pricing abuses that could fall within the parameters set by Section 6(8).
- H66 HAL is concerned that *'the CAA seems to prioritise a marginal "price" benefit, in the context of the overall ticket price'*<sup>33</sup> and considers that it is not able to reconcile this statement with the CAA's statement that airport charges make up a relatively small proportion of the airline opex cost-stack.<sup>34</sup>
- H67 In response to the first point, and as outlined in appendix G, the CAA considers that, given the proportion of ticket fare represented by charges levied by airports, the individual abuse on a per passenger basis may appear low. For example, a doubling of HAL's charges over Q6 would only amount to around an additional £20 per passenger in a ticket price.

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<sup>33</sup> HAL, Response to CAA's Market Power Assessment, 26 July 2013, paragraph 4.1.2.

<sup>34</sup> HAL, Response to CAA's Market Power Assessment, 26 July 2013, paragraph 4.1.9.

However, given the total number of passengers the scale of even low level abuse is likely to be significant in aggregate.

- H68 While the costs to an individual of tackling such an abuse are likely to far outweigh the benefits of doing so, a licence reduces these costs significantly, as the CAA is able to assess the adverse effects and abuse overall.
- H69 In response to the later point, as the CAA has previously stated, up to 20 per cent of airlines opex is accounted for in charges levied by airports and would therefore represent no more than this in the ticket price. Contrary to HAL's typification, the airport charge as a proportion of the total ticket cost is not negligible. Therefore, increases in airport charges are likely to have an effect on airlines' profitability and/or consumers' ability to travel depending on the competitiveness of the airline industry. The extent of this effect may vary according to the commercial situation of individual carriers and by reference to the margins on particular routes.
- H70 The current and proposed RAB-based framework for regulating HAL sets a cap on the aeronautical revenue per passenger comprising landing charges, parking charges and passenger terminal charges. Charges on non-passenger traffic (e.g. cargo) are required to be no more than those for the equivalent passenger aircraft. Discounts that were included in the published airport charges, for example for traffic growth, are included in price cap calculations while those that are negotiated between individual airlines and the airport operator are not.
- H71 As discussed in the appendix on the indicators of market power (appendix F), the CAA notes that:
- Since having an independent price cap, HAL has historically priced to the cap.
  - HAL does not agree discounts outside published charges.
- H72 Given the premium on the value of landing slots at Heathrow (indicating the excess demand at Heathrow) and the Government moratorium on capacity expansion, combined with HAL pricing to the cap, there is a reasonable expectation that, if the price cap were removed, HAL would seek to increase prices. This is further supported by the difference in pricing between the HAL's business plans and the Q6 Initial Proposals and the Q6 Final Proposals.
- H73 In support of the above, the average price proposed initially by HAL was £24.36 compared with the CAA's average price in both the Q6 Initial and Final Proposals a difference of approximately £4 per passenger arises. The proposed RAB licence sets an average price of £19.74 over a period



of 4 years and nine months (or £19.83 over a five year period), which leads to at least a £282 million per year anticipated benefit that from regulatory intervention.

- H74 The CAA notes HAL's concerns with the use of its pricing proposals as outlined in its Initial Business Plan proposals. However, this is a clear indication of HAL's pricing intent as it was proposed prior to the regulatory intervention by the CAA for the Q6 period. Even with the lower average price proposed in the revised business plan of £23.43 (which covered a period of four years and nine months), this still leads to at least a £237 million per year anticipated benefit from regulatory intervention.<sup>35</sup>
- H75 As discussed in the analysis of Test B (appendix G), in the absence of regulation, competition law alone would be unlikely to provide sufficient protection against abuses of SMP by HAL, particularly against the likely risk of excessive pricing mainly due to the difficulties associated with identifying and proving excessive pricing in any complaint or proceedings (always in the absence of regulation).
- H76 As part of the Q5 review regulation the CAA strengthened the Monopolies and Mergers Commission's requirement on HAL to provide information on costs and revenues for a number of specified activities not included in the price cap, by requiring that charges for those activities (such as check-in desk, baggage handling charges and staff car parking) are cost-reflective. This requirement applies in the proposed RAB Licence.
- H77 The provision of users with additional information which enables them to view and assess the level of charges for several other activities, and services, is likely to strengthen their ability to address concerns of excessive pricing and as such is likely to offer better protection against the risk of excessive pricing.
- H78 For example, the proposed regulation only allow 90 per cent of the costs of changes to security requirements to be passed on to airlines (subject to a deadband), to encourage the airport operator to implement changes to requirements efficiently. This serves to limit the range within which prices can rise, subject to changes in costs for new procedures. In a deregulated environment, it would be unlikely that HAL would face sufficient incentive to implement changes efficiently.
- H79 Overall, the proposed RAB-based regulation therefore appears to offer protection against the risk of pricing abuses (such as excessive pricing) by HAL, through price caps, limitations on price rises through the

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<sup>35</sup> HAL, Q6 Alternative Business Plan, CAA/Q6/73, 19 July 2013.

requirement to be cost-reflective and through the provision of additional cost information to users.

H80 Against the above benefits, there is a risk that the price cap is either set too high or too low. However, the risk of setting the price cap too high is minimised by the following factors:

- The CAA requires that charges are cost-reflective.
- Charges are set through a transparent regulatory process in line with the duties of the CAA as specified in the CA Act and having regard of the relevant principles, during which stakeholders have the opportunity to discuss and provided evidence on the respective issues related to costs, efficiency, investment plans, etc.
- In the case that a price cap is set too high, any of the parties affected may request a review to be re-opened by the CAA.
- To some extent, the risk of setting prices too high may be mitigated by the presence of competition law, although the limitations highlighted under Test B still apply.

H81 One of the key concerns identified in earlier CAA analysis was the risk that the CAA may set the price cap too low, distorting competitive and investment decisions at other airports. This may affect the development of the market over time, potentially to the detriment of consumers. It may also adversely affect airline locational decisions.

H82 However, the CAA considers, as with the risk of setting prices to high, the same factors set out in H80 mitigate against the risk of setting prices too low.

H83 Furthermore, the CAA considers that there has been little (or no) evidence that price controls on HAL have had a negative effect on other airports, as significant investment is still occurring in airports across the south east of England. In particular, the evidence suggests that:

- London Luton Airport Operations Limited is advancing investment decisions and has recently put forward a planning application to increase Luton's capacity to 18 million passengers per year.<sup>36, 37</sup>

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<sup>36</sup> [http://www.eplan.luton.gov.uk/plannet/documentstore/DC19512388-225-1\\_01\\_A.PDF](http://www.eplan.luton.gov.uk/plannet/documentstore/DC19512388-225-1_01_A.PDF).

<sup>37</sup> <http://www.luton.gov.uk/news/Pages/Planning-application-received-from-London-Luton-Airport-Operations-Ltd.aspx>.

- STAL, recently sold for a 10 per cent uplift on the notional RAB<sup>38</sup> and has commenced significant investment plans.<sup>39</sup>
- Gatwick Airport Limited (GAL) has launched a review in the development of a second runway.<sup>40</sup>
- In November 2012, Birmingham Airport Holdings Limited broke ground on the construction of its runway extension.<sup>41</sup>

- H84 Another issue resulting from price controls under the RAB-based regulation is the ability of the airport operator to properly finance its operations. Although the CAA's duties and functions in relation to licensing under the CA Act can, in principle, be applied in a way that focuses largely on the need to limit prices, the CAA also needs to take account of its section 1 duties. This includes section 1(3)(a), which requires the CAA to have regard to the need to ensure that each licence holder can finance the provision of airport operation services in the licence area.
- H85 When setting price caps, the CAA always considers the ability of a regulated airport to finance its operations by enabling it to recover the efficient level operating and capital costs, including capital wear and tear (depreciation) and a fair return to the providers of debt and equity.
- H86 In relation to the ability of a regulated airport to properly finance its operations the CAA also highlights that HAL never reported any such issues under current regulation, which leads the CAA to conclude that the likelihood of this risk occurring is not significant.
- H87 Overall, the CAA considers that, given that HAL holds a position of SMP in the relevant market, the proposed RAB Licence provides net incremental benefits over the Existing Regulation in the interest of the users of air transport services by ensuring that:
- Prices charged are cost-reflective;
  - The overall level of charges is capped;
  - HAL is limited in its ability to charge excessive prices;

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<sup>38</sup> PwC, April 2013, Cost of capital For UK Designated Airports: Paper on the split cost of capital and skewed returns – prepared to the Civil Aviation Authority, available at: <http://www.caa.co.uk/docs/78/Q6PwCCofCapitalSplitSkewed.pdf>, p. 18.

<sup>39</sup> STAL, <http://www.stanstedairport.com/about-us/media-centre/press-releases/transport-secretary-launches-%C2%A380-million-terminal-redevelopment>.

<sup>40</sup> See <http://www.gatwickairport.com/newrunway/>, accessed 10 April 2013.

<sup>41</sup> See <http://www.birminghamairport.co.uk/meta/news/2012/11/work-starts-on-birmingham-airports-runway-extension.aspx>, accessed 10 April 2013.

- Price changes are predictable since they occur in line with a stable pricing mechanism depending upon changes in the underlying level of efficient costs;

H88 While the CAA acknowledges that there are certain risks, its regulatory experience so far, and the provisions of the current RAB-based regime lead it to consider that these risks are likely to be minimised and are clearly outweighed by the potential benefits of a RAB-based regulatory licence.

## Impact 2: Efficiency incentives

H89 The main advantages of the current RAB-based licence regime in relation to efficiency are:

- It provides efficiency incentives for the regulated airport operator. HAL has an incentive to outperform the efficiency assumptions made at the start of the regulatory period as it can retain the gains from outperformance during the control period.
- The earlier the efficiency gains the longer they are retained in the control period, so the efficiency incentives diminish during the control period.
- The regulator mimics the market forces of effective competition by challenging HAL's reported operating and capital costs and efficiency assumptions putting downward pressure on them.

H90 As discussed in the chapter covering the indicators of market power (appendix F), the CAA has reviewed a range of evidence related to HAL's opex and capex efficiency, including several opex benchmarking studies.<sup>42</sup> This evidence, which is described also in the Q6 Final Proposals, indicates that:

- There are areas where efficiency at Heathrow can be improved. In particular, evidence from a number of independent benchmarking studies – studies which were top-down and bottom-up, and were carried out by different consultants following different methodologies and approaches – all point to areas of inefficiency at Heathrow.

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<sup>42</sup> These studies include: (1) Air Transport Research Society 2011 Airport Benchmarking Report; (2) Leigh Fisher 2011 Airport Benchmarking Report; (3) Booz Allen 2012 European Airport Benchmarking Report commissioned by HAL; and (4) Steer Davies Gleave 2012 Stansted Mid Q Review Report commissioned by the CAA and the CAA's own benchmarking analysis described in the Q6 Initial Proposals.

- Inefficiency was also identified by HAL's own consultants and was reflected in material submitted to the CAA.
- The CAA has also seen no evidence from HAL, including in response to the Consultation, regarding how competitive constraints have driven the efficiency initiatives that HAL has pursued.
- The identified inefficiencies at Heathrow are consistent with HAL enjoying a position of SMP in the relevant market. That is, HAL is facing insufficient competitive pressures to enhance its operating efficiency by driving operating and capital costs towards competitive levels.

H91 The evidence for this conclusion can be summarised as follows:

- Benchmarking evidence<sup>43</sup> shows that HAL's opex per passenger is very high relative to the sample average, and higher than several comparable operators of large hub airports such as Hong Kong, Atlanta and Amsterdam Schiphol.
- The CAA's benchmarking evidence shows that adjusted opex per passenger at Heathrow has risen significantly faster than the sample average since 2000, suggesting a relative decline in efficiency.
- HAL has one of the highest operating costs per passenger within the benchmarked group of comparator airports.
- Even adjusting for the inherent costs associated with operating Heathrow, it moved from having the second highest opex per passenger to fourth place (after Munich, Paris Charles de Gaulle and Zurich Airports).
- Staff costs are currently much higher than comparators as HAL sources labour from a high cost London borough.
- While utility contracts are now more in line with market rates, utility costs could be further improved (if it was not constrained by a continuing agreement).<sup>44</sup>

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<sup>43</sup> See footnote above.

<sup>44</sup> Booz & Co, European Airport Benchmarking Study 2012, p. 6.

- The bottom-up IDS Employment cost benchmarking study found evidence of inefficiency in several areas related to wage and pension costs. This study, which is based on an internationally established methodology, was conducted in consultation with HAL (and on many occasions HAL's comments were taken on board and reflected in the analysis).
- Wage growth at HAL between 2006 and 2012 was 1.6 per cent above the average across the wider economy.
- There is some evidence of grade drift across staff groups leading to a 'virtual de-population of the lower grades'. For example, there are now three Leading Fire Fighters for every Fire Fighter.
- Based on a three month sample (June to August 2012), the estimated absence rate at HAL was 7.6 days per employee per year. This is higher than the industry average of 6.8 days.
- Overall the study estimated that employee total cash reward at HAL was between 10 per cent and 21 per cent higher than benchmarks.
- The defined benefit and defined contribution pension schemes were both significantly higher than its comparators.
- Relatively poor performance on the passenger security lane flow (an issue that HAL accepts that it requires improvements).
- The potential to increase staff rostering efficiency by as much as 10 per cent.
- HAL, through its actions, also appears to verify that staff costs and pension scheme costs are too high and proposed wage reductions<sup>45</sup> of [3<] per cent in real terms and reducing pension costs<sup>46</sup> from thirty three per cent of pay to [3<] of pay in the latest Q6 business plan that it submitted to the CAA.
- Airlines have also identified concerns with the level of efficiency seen at Heathrow.

H92 Given the scale of efficiencies identified in appendix F (the section analysing HAL's efficiency), the CAA has concluded that the evidence is consistent with an operator enjoying a position of SMP in the relevant market not facing sufficient competitive pressure. As a result, it appears unlikely that, in the absence of a RAB-based regulation promoting HAL's

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<sup>45</sup> Source: HAL [3<].

<sup>46</sup> GAD, Review of pension costs for Heathrow Airport, 2013, p. 10.

opex and capex efficiency, HAL would have a sufficient competitive pressure to operate efficiently. On this basis, the CAA considers that there are incremental benefits of licence regulation in relation to efficiency.

H93 The strength of efficiency incentives will depend both on the particular type and tightness of the regulatory regime.

H94 The CAA acknowledges that against the benefits of the RAB Licence there are also risks associated with the distortion of incentives between opex and capex efficiency. In particular, there is the risk of setting opex and capex efficiency targets too high or too low. However, such risks are minimised by a number of factors, namely:

- The use by the CAA of a number of alternative efficiency analyses and benchmarking exercises enabling the cross checking of HAL's efficiency performance.
- The open and transparent Review process as specified in the CA Act and having regard of the relevant principles, during which the various stakeholders have the opportunity to discuss and provided evidence on the respective issues related to costs, efficiency, investment plans, etc.
- In case that the efficiency targets is set too high or too low, any of the parties affected may request a review to be re-opened by the CAA.
- To some extent, the risk of setting prices too high as a result of incorrectly setting the efficiency targets, may be mitigated by the presence of competition law, although the limitations highlighted under Test B still apply.

H95 The RAB Licence provides incentives to outperform the regulatory settlement and a flexible RAB approach with core and development capex, may improve incentives for the planning and efficiency of capex. The CAA acknowledges that the current regulatory framework can skew incentives for efficiency gains towards the start of the control period. Nevertheless, the strength of the incentive for the airport operator to be efficient will depend on the level of the price cap. Where an airport operator has SMP, and if the price cap is set too low, there may be less of an incentive to be efficient as the airport operator will already be making reasonable profits<sup>47</sup>, particularly where such efficiency gains may be used by the regulator to set tighter price controls in the future.

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<sup>47</sup> This is called X inefficiency and was first defined by Leibenstein, Harvey (1966), "Allocative Efficiency vs. X-Efficiency", American Economic Review 56 (3): 392–415.

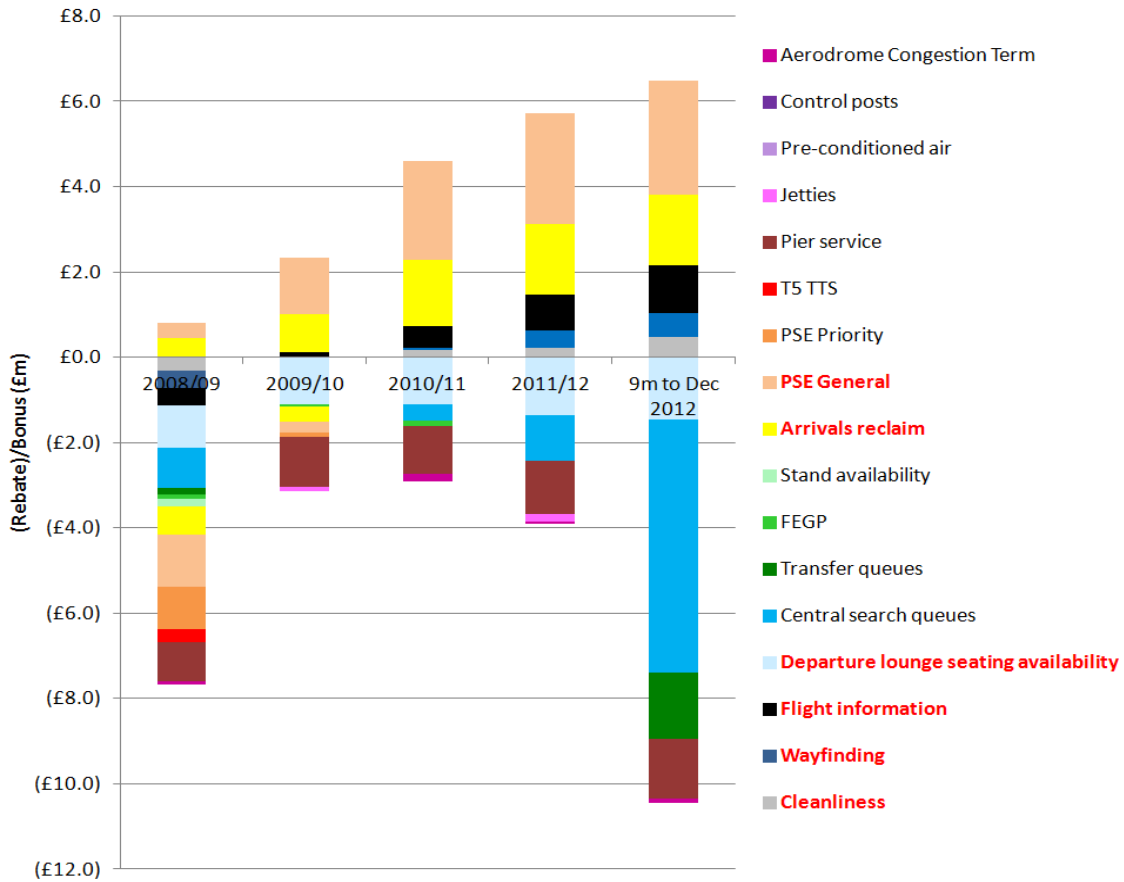
- H96 Based on this analysis, and given the current and historic inefficiencies at Heathrow, a price cap under a RAB License is likely to provide stronger efficiency incentives on the airport than those that it would face in a deregulated environment. Overall, the CAA considers that given that HAL holds a position of SMP in the relevant market the proposed RAB Licence is likely to have additional net benefits for the users of air transport services by promoting the operating and capital efficiency of HAL.

### **Impact 3: Protection against the failure to meet service quality standards that passengers require**

- H97 The Q5 service quality regime for HAL incorporates a service quality rebate scheme, with targets and rebates paid, set at a maximum of seven per cent of airport charges, for underperformance across eighteen passenger and airline facing metrics and a service quality bonus scheme, with bonuses paid, set at a maximum of 2.24 per cent of airport charges, for outperformance across six passenger facing measures.
- H98 As discussed in the Consultation, to better understand the performance of the individual elements within the SQR scheme, the CAA has considered the breakdown of total rebates and bonuses by the various elements (see Figure H.1 below).



**Figure H.1: Q5 SQR and Bonus Performance**



Source: Q5 Service Quality Performance, Heathrow Airport, Full Business Plan - Part E

Note: Elements labelled in red are eligible for bonus payments

H99 Having considered evidence from a range of sources, the CAA considered that:

- HAL’s service quality performance has improved in some areas during Q5.
- However, the improvements that have been observed in some areas appear to have been at the expense of other areas.
- Heathrow appears to be at or slightly above the target levels on service quality.<sup>48</sup>

<sup>48</sup> In coming to this view, the CAA noted that in Q5 the SQR scheme captured five areas of HAL’s service quality: (1) passenger satisfaction – with metrics taken from HAL’s Quality of Service Monitor (QSM) survey and covering flight information, cleanliness, way-finding, and departure lounge seating availability; (2) security queue times – with metrics based on queue times for central search, transfer search, staff search and control posts; (3) passenger operational elements – with metrics based on the availability of passenger-sensitive equipment (PSE), track transit systems, and arrivals reclaim (baggage carousels); (4) airline operational elements – with

- H100 The CAA also outlined that discussions with HAL and the airlines on their own research indicated a broad consistency with the results outlined above.<sup>49</sup>
- H101 HAL considered that if the airport was not regulated, it was likely that there may be a reduction in scope of the regime with a core level of services with greater potential for differentiation tailored more closely to individual airline needs. HAL referred to the examples of de-regulation in other sectors. HAL noted the changes in the service quality regimes in the retail telecommunications and energy supply, which saw gradual moves away from regulator determined regimes to a wider set of commercial and service quality packages.<sup>50</sup>
- H102 HAL's evidence suggests that, absent regulation, it may take a more tailored approach to the development of its service quality regime. Were there to be a reduction in scope, the cost of such a scheme would likely be lessened. In such an environment, the enforcement of the scheme would be through airlines that are party to the bespoke agreements.
- H103 However, due to the imposition of service quality targets by economic regulation, the CAA was not able to reach a clear conclusion on whether Heathrow's observed service quality reflects competitive pressures or a response to the price control incentives provided by the SQR scheme. In addition, the level of service quality experienced at Heathrow may reflect the level and the efficiency of the capex and opex incurred by HAL.
- H104 The RAB Licence can address service quality issues, although it could also impose risks. These risks centre around setting the wrong set of service quality requirements, for example if the elements of service quality measured, and associated financial incentives, do not match passengers' priorities or there is a focus on attributes that can be easily measured. There is also a risk that RAB licence regulation can fix service quality requirements at a particular level during a control period when circumstances and requirements may change.
- H105 Overall, the CAA considers that the SQR scheme has been proved to be a useful tool in promoting the service quality standards to the benefit of the air transport users and as a result it will be maintained during Q6 indicating that the proposed RAB Licence provides net benefits to the

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metrics covering pier service, stands, jetties, FEGP (Fixed Electrical Ground Power), PCA (Pre-Conditioned Air), and stand entry guidance. Metrics are generally based on the availability of these elements.

<sup>49</sup> See Chapter 6.

<sup>50</sup> Source: HAL [§<].

promotion of service quality standards and the protection of air transport users from service quality standards failure.

#### Impact 4: Investment incentives

H106 RAB-based regulation, when properly designed provides incentives for investment since:

- It ensures that planned investment can be recouped by entering the regulated airport's RAB. In particular, the stability and predictability of the RAB mechanism provides a stable framework for investment since it enables the recouping of the investment through a stable and predictable mechanism of revenue recovery.
- New capex is reviewed and agreed with the CAA as part of the regulatory process prior to its realisation.
- Investment is rewarded through a fair rate of return on which is known ex-ante providing the required market returns to equity and debt capital providers;
- In case of unpredicted justified investment cost overruns (e.g. due to unpredicted price increases of capital goods, extraordinary circumstances, etc.) the airport operator may recover part or all of those expenses.
- The opex required to make operational the new investment is also recouped through the RAB mechanism.
- The airport operator is guaranteed to receive compensation for its capital wear and tear through the depreciation mechanism.

H107 However, against the above listed benefits, it is widely recognised that RAB-based regulation may distort investment incentives by encouraging too much or too little investment. For example, in 2007 the CAA stated that:

- RAB-based regulation provides an incentive to invest by providing comfort to the regulated company that efficient and economic investment can be recouped. However, it could distort incentives and could, in certain circumstances, lead to too much investment too soon which could give rise to a major cost to users and distort their incentives.
- Regulation can affect investment incentives across airports as competing airport operators will need to respond and compete with any new investment, irrespective of whether the new investment was efficient.

- Under-investment could be protected through competition law as proposed investments were incremental, rather than lumpy, and actual airport investment could be compared to relatively well-developed investment plans for the expansion of the airport.
- H108 The possibility of the RAB-based regulation to distort investment incentives was also raised by DfT in 2008, where it noted that:
- RAB-based regulation could distort new investment incentives, although the impact of distortions from regulation was difficult to separate from other factors affecting investment decisions, such as the planning process.
  - Given the scale of investment being considered at Stansted, and the options available to the CAA to address the distortions to incentives through different approaches to price regulation, the impact of the distortions to incentives are unlikely to outweigh the beneficial effects of regulation.
- H109 HAL noted the potential for a RAB approach to lead to capex bias as has been seen in other sectors. However, HAL did not consider that this was the case at Heathrow as it had not been able to achieve the required cost of capital over recent control periods (a precondition for any capex bias).<sup>51</sup>
- H110 The CAA recognises that with respect to investment incentives the key issue with the RAB-based regulation is the over or under-rewarding of capital investment. With regards to setting returns on capital too high, RAB-based regulation can cause a clear bias towards capital-intensive solutions over those that can be achieved through opex, which maybe more efficient in the long-run. Counter to this is the risk of setting the reward for investment too low, in which case the regulated company is likely to minimise capital investment, if it invests at all.
- H111 As discussed in the Consultation, HAL stated that it had not made its allowed return in recent price control rounds due to underperforming traffic. However, HAL is still in the process of investing significant amounts of capital and its business plan indicates that it will continue to invest more. As a result, the CAA considers that the risk of under-rewarding investment currently appears to be minimal.
- H112 While acknowledging the possibilities for capex bias within RAB-based regulation, the CAA does not currently consider that, in the case of Heathrow, a significant bias is likely to exist. However, as noted above, Heathrow is undergoing significant expansion of facilities and this will

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<sup>51</sup> Source: HAL [§<].

need to be monitored going forward. A RAB-based licence allows the CAA to ensure that new facilities are procured in the most efficient way to the protect users against paying for the development of gold plated or inferior investments.

## Impact 5: Operational resilience

- H113 The CAA considers that good operational resilience plans are needed to protect the interests of end users. The consequences of severe disruption due to snow in January and December 2010, as well as severe disruption due to the Icelandic ash cloud, highlighted the lack of adequate emergency planning at many airports. A number of reports<sup>52</sup> looked at operational aspects of winter resilience, and the impacts on passengers, and made a number of recommendations.
- H114 In May 2011, the South East Airports Taskforce (SEAT, set up in June 2010) subgroup assigned with the responsibility to propose ways in which the operational performance of Heathrow, Gatwick and Stansted could be improved within the constraints of the current capacity caps, made a number of recommendations on punctuality, delay and resilience, including the need to develop performance charters setting out operational plans and cross-industry co-ordination and controls to manage and minimise disruption.<sup>53</sup> Subsequently, the three airport operators took these recommendations forward but progress was not as fast as it was hoped, partly due to questions of accountability and enforceability.
- H115 In a deregulated market, it would be for the airlines to enforce any redress for disruption going forward. However, the disruption in 2010 highlighted inconsistent compliance by airlines with their obligations under the denied boarding regulations (EC261). The CAA does not consider that the interest of airlines and those of passengers are likely to be fully aligned in situations of disruption. As a result, the CAA considers that a licence condition gives greater protection to users. A licence can be used to

<sup>52</sup> The Quarmby report, Oct & Dec 2010 (<http://transportwinterresilience.independent.gov.uk/>), the Transport Select Committee report May 2011 (<http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtran/794/79402.htm>), the Begg report on Heathrow, March 2011 ([http://www.baa.com/static/BAA\\_Airports/Downloads/PDF/BeggReport220311\\_BAA.pdf](http://www.baa.com/static/BAA_Airports/Downloads/PDF/BeggReport220311_BAA.pdf)), and CAA reports ([http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20\\_2\\_.pdf](http://www.caa.co.uk/docs/5/CAA%20review%20of%20snow%20disruption%20-%20Final%20Report%20-%20WEB%20VERSION%20_2_.pdf) and <http://www.caa.co.uk/docs/5/CAA%20issues%20facing%20passengers%20during%20the%20snow%20disruption%20FINAL.pdf>).

<sup>53</sup> DfT, <http://assets.dft.gov.uk/publications/south-east-airports-taskforce-report/south-east-airports-taskforce-sub-group-report.pdf>.

compel or incentivise HAL to adopt certain behaviours regarding the needs of users (passengers and cargo owners) that, as a monopoly provider without a direct contractual relationship with the end user, it might not otherwise adopt.

- H116 A licence condition could also be useful in situations where there is no agreement between the stakeholders to facilitate further progress to incentivise a greater willingness, or even requiring them, to take their stakeholders' needs into account, as well as encouraging them to use the levers at their disposal to encourage and co-ordinate the relevant stakeholders to greater effect.
- H117 There is a risk that a licence condition could create perverse incentives by limiting the ability of the licence holder to negotiate effectively, or by adversely altering the balance of risks that have already been agreed between the various parties. However, in situations where there is a stalemate, a licence may have benefits by changing this balance. A licence condition may also impose costs, from developing the associated resilience plans, but these are likely to be relatively small and be outweighed by the efficiency savings and reputational benefits from managing emergencies more effectively. Such conditions can also be modified in response to changed circumstances or concerns.
- H118 There is a benefit to users of air transport services by protecting their interests in terms of improved resilience. However, ultimately users will pay for this improved resilience. Therefore, the resilience requirements must not lead to costs in excess of users' willingness to pay. Before imposing licence conditions the CAA would therefore need to consider its duty not to impose unnecessary regulatory burdens on the airport operator; regulation should be proportionate and should only target those areas where action is needed.
- H119 In summary, the CAA maintains its Consultation view that there are benefits to passengers and cargo owners having good operational resilience plans for times of disruption and there could be a role for an appropriately framed licence condition to facilitate this.
- H120 Depending on the impact of such operational resilience plans on HAL's costs, HAL could recoup and accommodate such foreseen costs under the proposed RAB Licence regime.

## Impact 6: Financial resilience

- H121 The Government has been keen for the CAA to consider whether the licence could be used to strengthen the financial resilience of airport operators, in line with the approaches commonly seen in other regulated sectors. Financial resilience is important as financial distress could cause detriment to users' interests in both the short and longer-term. The economics of an airport, whose operator holds a position of SMP, suggest that, even in a time of financial distress, the airport is likely to remain open as it would generate positive cash flows. However, there could be a temporary closure, for example, to allow an administrator to resolve legal and operational issues. Financial distress may also lead to reduced expenditure on the airport with implications for future service quality.
- H122 As noted in the Initial Proposals, since aspects of a utility style ring-fencing would conflict with the current financial arrangements at HAL, it would be unlikely to be in the passengers' interest to introduce full ring-fencing as part of a licence. However, if there is a change in circumstances and the CAA considers that it is in the passenger interests (i.e. the benefits outweigh the costs), then consistent with DfT's policy intent, it would be also possible to move towards a complete ring-fencing over time under a licence based approach.
- H123 The Q6 Initial Proposals set out a number of requirements that the CAA considers are necessary to facilitate financial resilience, including:<sup>54</sup>
- restriction on business activities;
  - certificate of adequate resources;
  - parent company undertakings;<sup>55</sup>
  - continuity of service plan;
  - minimum credit rating;
  - prohibitions on cross guarantees; and
  - report on changes in contractual ring-fences.

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<sup>54</sup> For a detailed discussion on the issues surrounding financial resilience see Chapter 15 of the CAA's proposals for the regulation of HAL. See CAA (2013), Economic regulation at Heathrow from April 2014: initial proposals, CAP 1027 available at: <http://www.caa.co.uk/docs/33/CAP%201027%20Economic%20regulation%20at%20Heathrow%20from%20April%202014%20initial%20proposals.pdf>.

<sup>55</sup> For a licence-based approach this is a parent company undertaking not to do anything that would be likely to make the licence holder do anything to breach its licence.

- H124 As a result, the CAA maintains the view it outlined in the Consultation that, for financial resilience consisting of the issues set out above, licence-based regulation would have a number of potential benefits to users that outweigh its implementation costs.
- H125 Depending on the impact of such operational resilience plans on HAL's costs, HAL could recoup and accommodate such foreseen costs under the proposed RAB Licence regime.

### Impact 7: Direct costs

- H126 The costs of RAB Licence regulation include the CAA's direct costs of running and maintain the regulatory regime, the cost to the airports and the airlines, the cost of appeals as well as various forms of indirect costs that are not readily quantifiable, such as the impacts on incentives set out above, the potential costs of management distraction by the regulatory process and the costs of disincentivising a commercial approach to running an airport business.

#### CAA direct costs

- H127 The CAA's annual charges for economic regulation at Heathrow are around £1.6 million per year, with additional costs of around £0.5 million per year during the periodic review.<sup>56</sup> In addition, there are likely to be costs of any appeals to the Competition Appeal Tribunal (CAT) and the Competition Commission (CC) under the new appeals processes set out in the CA Act. The extent and cost of these appeals is unknown. Based on this the additional CAA costs could be argued to be around £2 million per year, on average, during a five year control period.

#### Costs to airports and airlines

- H128 In addition to the costs of the CAA, there will be the cost of management and regulation staff at the airport and its airlines, as well as the direct costs of compliance and maintenance of the RAB-based regulatory requirements.

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<sup>56</sup> This is based on around 35 million arriving passengers at Heathrow and a charge of 4.75 pence for designated airports and 1.50 pence per arriving passenger for the Q6 review for Heathrow. Source: CAA charges 2013/14 consultation document. This document can be accessed at: <http://www.caa.co.uk/docs/1352/CAACHarges1314ConsultationDocWebFinal.pdf>. In this document there is still a degree of cross subsidy from designated airport to non designated airports.



- H129 HAL considered that the direct costs of the price control, and consequent measures, could amount to more than £10 million.<sup>57</sup> Netting off the cost associated with the CAA would equate to around £8 million per year.
- H130 In addition to these costs are the costs of airlines. Airline involvement in regulation varies but, apart from the permanent role of the ACC at Heathrow, most airline representatives are spread across a number of airports and airline sectors. In general, two airlines tend to be most heavily involved in regulatory matters at Heathrow: British Airways and VAA, with other airlines having varying levels of involvement. On this basis, the CAA considers a high level of airline costs from the current regulatory arrangements to be, at most, an average of £1 million per year during a regulatory cycle.<sup>58</sup>

### Overall direct costs

- H131 The above analysis suggests that the direct costs of regulation under the proposed RAB Licence regulatory regime are likely to be around £12 million per year. The main costs, however, are likely to be indirect, in terms of any potential distortions to incentives and these are not readily quantifiable. A discussion of those indirect costs is given below.

### Impact 8: Indirect adverse effects

- H132 The discussion above has highlighted a number of potential distortive effects from RAB Licence regulation, including:
- The increased rigidity of a regulatory system, in particular in relation to consultation requirements and changes in charges and service quality.
  - The distortions to incentives on opex, non-aeronautical revenue and investment.
  - The disincentive to invest for new customers.
  - The requirement for capex plans to be set too far in advance.
- H133 In addition to the above listed adverse effects that could result from the proposed RAB Licence regulation, the CAA identified two further potential distortive effects that apply from a licence regulation in general. These are the potential of displacing a more commercial approach to running Heathrow's business and the distraction of HAL's management effort.

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<sup>57</sup> Source: HAL [redacted].

<sup>58</sup> This is based on an average involvement of 3-10 FTE, with an additional allowance for consultancy costs and management time.

**Displacing a more commercial approach**

- H134 One of the key areas in which RAB Licence regulation could create distortions is by displacing a more commercial approach. Under a market subject to conditions of effective competition and in the absence of regulation, airport operators and airlines may have an incentive to enter into bilateral contracts or deals through commercial negotiations. These deals could vary in terms of the duration, scope and service requirements depending on the needs of individual users and characteristics and the relevant negotiating powers of the parties involved. Bilateral contracts can also provide benefits to airport operators from traffic and growth commitments and the utilisation of new facilities. Such bilateral contracts characterise much of the competitive airport sector in the UK. The desirability of such deals has been also recognised by the CC.<sup>59</sup>
- H135 However, given HAL's SMP position in the relevant market the need to have a regulatory settlement in relation to prices, efficiency, service quality, etc. to constraint HAL's SMP, may adversely affect HAL's incentive to behave in a commercial way and displace such contracts as both the airport operator and airlines will want to know what the potential settlement is before agreeing to any deal.
- H136 The CAA has been keen to encourage commercial agreements where possible, for example on the extension of the Heathrow and Gatwick price controls and by encouraging a similar arrangement for Stansted which admittedly has made significant progress in achieving such deals with its major customers. The current regulatory framework has not prevented HAL from negotiating and reaching commercial bilateral contracts. Nevertheless, the CAA recognises that bilateral contracts may be more likely in a deregulated environment, not least as the regulated company would not be looking for the regulator to stand over any arrangements.
- H137 Consequently, while a regulatory settlement can create distortions by discouraging bilateral contracts from being agreed, it does not stop such agreements and, in cases where the airport operator has SMP, it can prevent the airport operator from abusing it. In addition, the CAA does not consider that the RAB Licence would prevent bilateral contracts being agreed with airlines.

**Management distraction**

- H138 The RAB-based licence regulation which is admittedly a resource intensive process could also distort HAL's incentives by driving its management to focus upon on maximising the value from a regulatory

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<sup>59</sup> Paragraph 5.16, Competition Commission (March 2009).

settlement, rather than focusing on improved efficiency, service quality and lower prices for the end users. In a deregulated environment, and under conditions of effective competition, there would be minimal regulatory distraction and the management of the airport operator would be focused purely on running the airport by focusing upon prices, efficiency and service quality for its customers and the end users.

- H139 However, the scale of regulatory distractions could be reduced through more flexible forms of regulation, for example with the more flexible RAB-based approach involving more airport operator and airline engagement, for example on capex plans, as the CAA has sought to adopt.

### Overall conclusion: RAB-based Licence

- H140 The CAA considered the incremental benefits of a RAB-based regulation over the Existing Regulation counterfactual across a number of areas that are most commonly recognised as affecting consumers' interests such as prices, efficiency and investment incentives, service quality standards and operational and financial resilience.
- H141 Against those incremental benefits the CAA has also considered the potential adverse effects of a RAB-based licence in terms of the direct costs, distortions to incentives, management distraction and crowding out of a more commercial approach etc. These adverse effects are minimised through a RAB-based licence due to a number of factors set out in the relevant analysis.
- H142 Given that HAL holds a position of SMP in the relevant market, the CAA's cost – benefit analysis suggest that the benefits of a RAB-based licence are likely to outweigh any adverse effects and as a result the CAA maintains the view it outlined in the Consultation.

### Assessment of alternative factual scenario: Licensing Generally

- H143 As already noted, for completeness, the CAA has also considered the costs and benefits of regulation by means of a license that is not in the form of a RAB-based Licence. In this section, the CAA considers that licensing scenario against the Existing Regulation counterfactual.
- H144 The assessment has been undertaken considering the same impacts as considered above in relation to prices, efficiency and investment incentives, quality standards, etc.<sup>60</sup>

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<sup>60</sup> The assessment of Existing Regulation conducted above is also relevant to the assessment of

H145 Given the conclusion of the cost-benefit analysis of the RAB-based regulation above, it has been established that at least one form of licence regulation, namely the RAB-based regulation reflected in the Q6 Final Proposals passes Test C.

### Impact 1: Protection against excessive prices

H146 Given that HAL holds a position of SMP in the relevant market, the CAA is likely to introduce some form of price control in other forms of regulation whether they be ex ante price caps or ex post price monitoring. The CAA is likely to set some form of price, revenue or hybrid cap based on the fair price as this has been calculated using RAB building blocks. Price caps could also be introduced using a long run incremental cost (LRIC) or pegging tariffs to comparator airports. While these approaches would have benefits in terms of certainty the problems with setting price caps using these approaches as set out in the Q6 Final Proposals. The CAA acknowledges that price monitoring on its own may not provide sufficient protection given the market power held by HAL.

H147 Licence regulation would also have benefits beyond price controls in terms of the ability to regulate the pass through of costs. While as set out in the Consultation the CAA acknowledges that there were risks from a licensing regime in general. For example, from the potential impact on agreeing bilateral contracts (although bilateral contracts are not prevented under alternative forms of regulation). The CAA considers these risks are outweighed by the potential benefits in terms of ensuring that prices charged are in users' interests.

### Impact 2: Efficiency

H148 Licence based regulation can be an effective way of promoting operating and capital efficiency. The strength of efficiency incentives will depend on the type of regulation. Licence regulation can also create adverse effects in particular through the distortion of incentives between opex and capex efficiency. In general, given that HAL holds a position of SMP in the relevant market, it appears that various forms of ex-ante regulation would be necessary to provide greater efficiency incentives than relying on market pressure alone.

- Alternative forms (revenue or hybrid cap) of a RAB-based approach, would provide incentives to outperform the price cap, but would have stronger efficiency incentives due to the tighter price cap

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this factual scenario and has been taken into account.

- A market based price cap, such as one based on LRIC or airport comparators or other forms of licence based price caps, will provide efficiency incentives as the price cap would be delinked from expenditure, although the strength of these incentives would depend on the accuracy of the calculations and the level of the price cap.
- Price monitoring, in the right circumstances could provide incentives for efficiency as prices would be delinked from expenditure with the strength of incentives dependent on the strength of competitive pressure and the perceived impact of any threat of more prescriptive regulation.

H149 Any form of licence regulation can include requirements for increased transparency, for example through the publication of detailed financial data in regulatory accounts. This can provide a strong incentive on airport management to be more efficient.

H150 Any form of licence can also include limits or checks and balances on elements of cost pass through, for example on second runway costs, which can improve efficiency. There will also be efficiency benefits from the threat of enforcement action or tighter regulation if efficiency does not improve.

H151 The CAA acknowledges that licence regulation can distort incentives, for example by concentrating efficiency gains at the beginning of the control period, where the benefits to the airport operator are greatest, although this does not seem to have prevented HAL from improving efficiency during the Q5 control period.

H152 Based on this analysis, the CAA considers that given HAL's SMP position in the relevant market, licence regulation in general is required to provide appropriate efficiency incentives given the absence of competitive pressures.

### **Impact 3: Protection against the failure to meet service quality standards that passengers require**

H153 A service quality regime sets out the clear expectations for passenger and airlines of their use of the airport facilities. The main benefit from a general licence to cover service quality is to guarantee the passengers value for money in the use of the services provided by the airport operator to the passenger and airlines. The main potential issue associated with licence regulation in general is the rigidity of the SQR regime.

H154 However, the CAA considers that in case of a licence it is likely that there is a trade-off between increasing rigidity and greater protection to

passengers, with potentially greater protection to passengers provided where there is a degree of rigidity backed up by licence regulation. The CAA considers that a greater degree of rigidity can provide benefits, in the absence of regulation, as service providers with SMP may have a financial incentive to provide lower service quality than would occur in a competitive market. If evidence emerges that a licence is inhibiting improvements because of this rigidity, the CA Act provides the scope to modify the licence as appropriate.

#### **Impact 4: Investment incentives**

- H155 As discussed under the evaluation of the RAB-based regulation section, the CAA acknowledges that licence based regulation can distort investment incentives, with a potential bias of RAB-based regulation towards capital spend and market-based approaches potentially leading to too little investment. However, the CAA considers that the Q5 RAB-based framework has not appeared to have resulted in too much investment in the current control period and there was the potential to strengthen investment incentives under market-based regimes by putting in place additional regulatory requirements.
- H156 Any form of licence regulation can provide incremental benefits by ensuring that investment is undertaken in the passenger interest. Licence regulation could also provide benefits from strengthening the consultation requirements for capital expenditure, although this could increase costs and rigidity.
- H157 The flexibility of a licensing system could be used to address other concerns with licence regulation such as fixing investment too far in advance and disincentivising investment for new customers.
- H158 Overall, the CAA considers that Licensing generally would provide benefits over Existing Regulation, particularly by ensuring that capex is undertaken in users' interests.

#### **Impact 5: Operational and financial resilience**

- H159 As discussed under the relevant section evaluating the RAB-based regulation, the CAA considers that requirements for operational and financial resilience could be introduced under any form of licence regulation. These measures, together with the back-up of the potential for enforcement action, would provide incremental benefits above the Existing Regulation counterfactual.

## Impact 6: Direct costs

- H160 Licence regulation, regardless of its precise form, will undoubtedly have costs. As set out in the assessment of the RAB-based licence the CAA's incremental direct costs (above), the CAA's annual charges for economic regulation at Heathrow are around £1.6 million per year, with additional costs of around £0.5 million per year during the periodic review.<sup>61</sup> In addition, there are likely to be costs of any appeals to the CAT and the CC under the new appeals processes set out in the CA Act. The extent and cost of these appeals is unknown. Based on this the additional CAA costs could be argued to be around £2 million per year, on average, during a five year control period.
- H161 While a RAB-based regulation is resource intensive, some of the alternative forms of regulation may be cheaper, for example there will not be a requirement to estimate individual building blocks and the expensive consultancy that this entails. However, a LRIC approach is likely to be also resource intensive as it requires the calculation of forward looking or modern replacement costs. Even a price monitoring regime would require some regulatory involvement from an annual review of costs and performance, with these costs likely to be in excess of £0.2 million per year and could be as much as the current regulatory arrangements.

## Impact 7: Indirect adverse effects

### Regulatory gaming

- H162 The CAA acknowledges that any form of licence regulation can lead a bid and counter bid approach. Such an approach is also a feature of commercial relationships, for example the negotiations around bilateral contracts in a normal commercial environment. Consequently, the CAA does not consider that licence regulation should necessarily result in any greater gaming than normal commercial negotiations.

### Crowding out a more commercial approach

- H163 The CAA acknowledges that bilateral contracts are less likely under price cap regulation, not least from the risk that a typical ten year bilateral contract is likely to span more than one regulatory period. Nevertheless, licence regulation in general does not prevent bilateral contracts and

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<sup>61</sup> This is based on around 35 million arriving passengers at Heathrow and a charge of 4.75 pence for designated airports and 1.50 pence per arriving passenger for the Q6 review for Heathrow. Source: CAA charges 2013/14 consultation document. This document can be accessed at: <http://www.caa.co.uk/docs/1352/CAACHarges1314ConsultationDocWebFinal.pdf>. In this document the CAA notes that there is still a degree of cross subsidy from designated airport to non designated airports.

Licensing generally can provide benefits on its own by ensuring that the terms of the contract are reasonable, reducing the risk of HAL abusing its SMP.

### Management distraction

H164 The CAA acknowledges that any form of licence regulation is likely to cause some element of management distraction. Any licence regime can be designed so as to minimise the potential detrimental impacts of management distraction including by incentivising of interaction between the airport operator and its airline community over key aspects of the licensing regime. However, as set out above, the CAA does not consider that the current RAB-based regime has caused significant distraction to operational staff.

### Conclusion on General Licensing

H165 As the foregoing analysis demonstrates, the precise nature of the benefits and the adverse effects of a licence regime will depend on the specifics of the licence adopted. There are significant differences in this regard along the spectrum between the various forms of RAB-based licence regulation at one end and a bare monitoring regime at the other.

H166 Overall, given that HAL holds a position of SMP in the relevant market, the CAA considers that a licensing regime offers the potential for substantial benefits for users, in terms of enforceability, price, efficiency, investment incentives and other impacts. While there will also be some adverse effects, the extent depends on the model of licensing adopted.

H167 Given the conclusion of the cost-benefit analysis of the RAB-based regulation above, the CAA has established that at least one form of licence regulation, namely the RAB-based regulation reflected in the Q6 Final Proposals passes Test C.

H168 Any particular model of licence regulation would have to satisfy the CAA's general duties, including that of targeted, necessary and proportionate intervention. The CAA has identified one particular means of license regulation amongst the range of possibilities, in respect of which it has concluded that the benefits are likely to outweigh the adverse effects. The CAA has therefore concluded that the benefits of license regulation in general are likely to outweigh the adverse effects in the circumstances of the present case.



## Conclusion on evidence and analysis on Test C

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H169 As the forgoing analysis makes clear, the CAA's judgement is that the benefits of licence regulation are likely to outweigh the adverse effects, whether by reference to a RAB-based Licence or to Licensing Generally.